

DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 04-0251
Indiana Corporate Income Tax
For the Years 1994 to 2000

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ISSUES

I. Applicability of the Indiana Adjusted Gross Income Tax and Gross Income Tax.

Authority: U.S. Const. art. I, § 8, cl. 3; U.S. Const. amend. XIV, § 8; IC 6-2.1-2-2; IC 6-3-1-1 et seq.; IC 6-3-2-2(a); 45 IAC 1-1-51; 45 IAC 3.1-1-55; Quill Corp. v. North Dakota, 504 U.S. 298 (1992); Complete Auto Transit, Inc. v. Brady, 430 U.S. 274 (1977); Int'l Harvester Co. v. Wisconsin Department of Taxation, 322 U.S. 435 (1944); Wheeling Steel Corp. v. Fox, 298 U.S. 193 (1936); Gregory v. Helvering, 293 U.S. 465 (1935); Commissioner v. Transp. Trading and Terminal Corp., 176 F.2d 570 (2nd Cir. 1949); Indiana Dept. of State Revenue v. Bethlehem Steel Corp., 639 N.E.2d 264 (Ind. 1994); Hoosier Energy v. Dept. of State Revenue, 572 N.E.2d 481 (Ind. 1991); Geoffrey, Inc. v. South Carolina Tax Commission, 437 S.E.2d 13 (S.C. 1993); Lanco, Inc. v. Dir., Div. of Taxation, No. 005329-97, 2003 N.J. Tax LEXIS 18; Del. Code Ann. tit. 30 § 1902(b)(8).

Taxpayer argues that the royalties it earned from licensing intellectual property were not subject to Indiana corporate income tax.

II. Apportionment Formula.

Authority: IC 6-3-2-1(b); IC 6-3-2-2(b); IC 6-3-2-2(c); IC 6-3-2-2(l); 45 IAC 3.1-1-39.

Taxpayer states that if it is subject to the Indiana's adjusted gross income tax, the audit's application of a single factor apportionment formula was erroneous because it distorted the amount of taxpayer's Indiana adjusted gross income.

III. Ten-Percent Negligence Penalty.

Authority: IC 6-8.1-10-2.1(a); IC 6-8.1-10-2(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer requests that the Department of Revenue (Department) exercise its discretion to abate the ten-percent negligence penalty made against taxpayer's additional corporate income tax assessment.

STATEMENT OF FACTS

Taxpayer is a Delaware company in the business of licensing intellectual property consisting of trade marks and service marks. Taxpayer is owned by a retail chain store which conducts business nationwide including retail locations within Indiana. The intellectual property originally belonged to the retail chain store but was transferred to taxpayer by means of an I.R.C. § 351 tax free exchange. In return for receiving ownership of the intellectual property, the retail chain store received 100 percent of the taxpayer's stock.

Thereafter, taxpayer and the retail chain store entered into a "Licensing Agreement" which enabled the retail chain store to continue use of the intellectual property it had previously owned. In return, the retail chain store paid taxpayer royalties based upon a percentage of net sales of products sold bearing the trademarks. The retail chain store paid approximately 3 percent of its net sales to taxpayer. The royalties were paid to taxpayer by means of an electronic fund wire transfer. Once taxpayer received the royalties, it loaned the money back to the retail chain store. Taxpayer loaned the money by means of an electronic fund transfer.

According to taxpayer, it also received royalties from "unrelated third parties such as joint ventures and franchisees."

Taxpayer did not file Indiana corporate income tax returns during the periods of time at issue. The Department of Revenue conducted an audit review of taxpayer's business records and found that because taxpayer was licensing the intellectual property for use within Indiana and because it received money for doing so, taxpayer should have been paying corporate income tax on that money. Accordingly, the Department sent taxpayer notices of "Proposed Assessment" covering 1994 to 2000. Taxpayer disagreed with the proposed assessments and submitted a protest to that effect. An administrative hearing was conducted during which taxpayer explained the basis for its protest. This Letter of Findings results.

DISCUSSION

I. Applicability of the Indiana Adjusted Gross Income Tax and Gross Income Tax.

The audit found that Indiana is the business situs of taxpayer's intellectual property and that income derived from the use of the intellectual property within this state constitutes Indiana source income properly taxable to the state of the Indiana. Taxpayer disagrees pointing out that it has no employees within Indiana and does not own tangible or intangible property within the state. Taxpayer argues that the audit's position is invalid because the proposed assessments allegedly violate the Due Process and Commerce Clauses of the United States Constitution.

A. Adjusted Gross Income Tax.

Indiana imposes an adjusted gross income tax on income derived from sources within the state. The adjusted gross income tax, IC 6-3-1-1 et seq., is an apportioned tax specifically designed to reach income derived from interstate transactions. Indiana Dept. of State Revenue v. Bethlehem

Steel Corp., 639 N.E.2d 264, 266 n. 4 (Ind. 1994). The legislature has defined “adjusted gross income” as follows:

(1) income from real or tangible property located in this state; (2) income from doing business in this state; (3) income from a trade or profession conducted in this state; (4) compensation for labor or services rendered within this state; and (5) income from stocks, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter. IC 6-3-2-2(a).

In order for Indiana to tax the income derived from an intangible, the intangible – such as taxpayer’s intellectual property – must have acquired a “business situs” within the state. 45 IAC 3.1-1-55 states that “[t]he situs of intangible personal property is the commercial domicile of the taxpayer . . . unless the property has acquired a ‘business situs’ elsewhere. ‘Business situs’ is the place at which intangible personal property is employed as capital; or the place where the property is located if possession and control of the property is localized in connection with a trade or business so that substantial use or value attaches to the property.”

The Department concludes that taxpayer’s intellectual property has acquired a “business situs” within Indiana. Taxpayer licenses the intellectual property for the exclusive use by the retail chain store which sells goods bearing taxpayer’s trade and service marks. Based upon the parties’ agreement and the independent valuation of the value of these marks, it is evident that the parties attach significant value to the trade and service marks. As the independent valuation states, “The use of the [] trade names would provide entry into the retail [] market, which could not be achieved without the acquisition of a well-known name.” Elsewhere, the valuation noted that, “The [] trade name is the leader in the retail [] market and a stronger name than the franchise names employed for comparison.”

The value taxpayer derives from the exploitation of the intellectual property is attributable entirely to activities occurring within the state of Indiana. The value of the intellectual property to the taxpayer consists of the ability to “place” that intellectual property within the state and to derive the consequent benefits attributable entirely to the intellectual property’s Indiana business situs. As the regulation itself states, “‘Business situs’ is the place at which [the] intangible personal property is employed as capital . . .” 45 IAC 3.1-1-55. The place at which “value attaches to the [intellectual] property” is within the state of Indiana. *Id.* The significant value attached to these properties derives entirely from the ability to assign the properties for use within the state. Taxpayer reaps benefits in the form of royalties directly attributable to retail sales made to Indiana customers.

However, taxpayer interposes several constitutional arguments which would have the effect of limiting Indiana’s ability to tax the income attributable to the intellectual property. Taxpayer states that “[t]he imposition of taxation on [taxpayer] as a foreign corporation violates the Commerce Clause and the Due Process Clause of the U.S. Constitution.” Taxpayer is correct in its assertion that both the Due Process Clause, U.S. Const. amend. XIV, § 8, and the Commerce Clause, U.S. Const. art. I, § 8, cl. 3, require that there exist a minimum connection between a

state and the object of the tax and that those constitutional requirements must be met before Indiana can exercise taxing authority over taxpayer's income.

In Quill Corp. v. North Dakota, 504 U.S. 298, 306 (1992), the Supreme Court stated that "[t]he Due Process Clause 'requires some definite link, some minimum connection between a state and the person, property or transaction it seeks to tax.'" However, the Court concluded that the due process requirement is satisfied "if a foreign corporation purposefully avails itself of the benefits of an economic market in the forum state . . . even if the [the taxpayer] has no physical presence in the state." *Id.* at 307. Although taxpayer's physical existence – measured by its business location, employees, and corporate existence – may be confined within Delaware's boundaries, taxpayer has directed its activities at the residents of Indiana and at the benefits conferred by Indiana in making it possible for taxpayer to conduct business within the state. Taxpayer has not been unwillingly brought into contact with Indiana by the unforeseen and unilateral actions of an independent third-party. To the contrary, there is every indication that taxpayer directed its activities toward licensing the intellectual property to the retail chain store and received substantial income from the use of the intellectual property within the state. The fact that Indiana confers protection, benefits, and opportunities upon taxpayer is apparent from taxpayer's simple ability to derive income from conducting business within the state. Therefore, under the standards set out in the Quill decision, the Due Process Clause does not prevent Indiana from taxing the income derived by taxpayer in availing itself of the Indiana business situs.

Taxpayer argues that Indiana may not tax its income by virtue of the protections afforded under the Commerce Clause. In Complete Auto Transit, Inc. v. Brady, 430 U.S. 274, 279 (1977), the Supreme Court outlined a four-part test for determining whether a state's exercise of its taxing authority is offensive to the Commerce Clause. The Court stated the exercise of the state's taxing authority would survive a constitutional challenge "when the tax is applied to an activity with a substantial nexus with the taxing State, is fairly apportioned, does not discriminate against interstate commerce, and is fairly related to the services provided by the State." *Id.* Taxpayer argues that the proposed tax violates the Commerce Clause because taxpayer does not have a "substantial nexus" with Indiana and because the tax is not "fairly apportioned."

Taxpayer claims that it does not have a "substantial nexus" with Indiana because it is not commercially domiciled in Indiana, does not have a business situs in Indiana, conducts no business in Indiana, derives no services from Indiana, and has no employees or property within the state. However, as the court in Geoffrey, Inc. v. South Carolina Tax Commission, 437 S.E.2d 13, 23 (S.C. 1993), *cert. denied*, 510 U.S. 992 (1993), noted, "It is well settled that the taxpayer need not have a tangible, physical presence in a state for income to be taxable there. The presence of intangible property is sufficient alone to establish nexus." That determination echoed the standard set out by the Supreme Court in Int'l Harvester Co. v. Wisconsin Department of Taxation, 322 U.S. 435, 441-442 (1944) when the Court stated that, "A state may tax such part of the income of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are subject to state regulation and which are within the protection of the state and entitled to the numerous other benefits which it confers." (*See also Wheeling Steel Corp. v. Fox*, 298 U.S. 193 (1936) "The rule that the taxable situs of intangibles is at the technical domicile of the owner is but a mere fiction, and will not be followed when the fact is clear that the intangible property has a situs elsewhere.") The contractual relationship

between taxpayer and Indiana parent company creates the requisite “substantial nexus” with Indiana necessary for Indiana to subject taxpayer to its adjusted gross income tax. By virtue of that licensing agreement, the retail chain store uses the intellectual property to enhance the value of the products sold within the state and to generate the sales which form the basis upon which the taxpayer receives a stream of royalty income.

In addition, the taxpayer argues that the proposed tax violates the Commerce Clause because the tax is not “fairly apportioned.” Taxpayer apparently argues that the income at issue should “apportioned” back to the state of Delaware. As the court in Hoosier Energy v. Dept. of State Revenue, 572 N.E.2d 481, 485 (Ind. 1991) stated, “As a general proposition, a state tax on interstate commerce must be fairly apportioned to prevent excessive taxes on such sale as each state takes its bite out of the interstate transaction as it passes through each taxing state.” Therefore, in order for a tax to meet the Complete Auto “fairly apportioned” requirement, the state must demonstrate that the taxpayer’s income is not consumed by multiple states exercising successive taxing authority over the same income in a manner which offends the Commerce Clause. However, taxpayer has presented no evidence indicating that the income is in anyway potentially subject to multiple taxation. The only other state which could conceivably exercise taxing authority over the income is Delaware, taxpayer’s putative business location. There is simply no indication that Delaware has or will subject the income to its taxing authority. To the contrary, Del. Code Ann. tit. 30 § 1902(b)(8) would seem to specifically exempt income derived from intellectual property from the state’s taxing authority. The Delaware statute states, in relevant part that:

The following corporations shall be exempt from taxation under this chapter: (8) Corporations whose activities within this State are confined to the maintenance and management of their intangible investments . . . and the collection and distribution of the income from such investments For purposes of this paragraph, “intangible investments” shall include, without limitation, investments in . . . patents, patent applications, trademarks, trade names and similar types of intangible assets

In the absence of any indication that taxpayer’s income would be subject to successive taxation by multiple states, taxpayer’s “fairly apportioned” argument must fail. To the contrary, the evidence supports the conclusion that the imposition of the state’s adjusted gross income tax meets the apportionment requirements set forth in Complete Auto.

Taxpayer cites to Lanco, Inc. v. Dir., Div. of Taxation, No. 005329-97, 2003 N.J. Tax LEXIS 18, for supporting its assertion that a state may not constitutionally subject an out-of-state corporation to that state’s income tax where the out-of-state corporation has no physical presence in the state and derives income only pursuant to a license agreement with another corporation that conducts a retail business there. Taxpayer correctly points out that the New Jersey Tax Court “determine[d] that the state may not assert nexus, absent physical presence against a corporation that receives income from the use of trademarks or other intangibles employed in a New Jersey business conducted by an affiliated corporation.” Id. at *34. However, the Department – unlike the New Jersey Tax Court – is unwilling to overlook the issues of common ownership and the issues concerning the manner and means by which ownership of the intellectual property was transferred from the retail chain store to taxpayer. *See* Lanco at *2. Taxpayer is paid millions of

dollars in royalties by retail chain store for no apparent purpose. There is no indication that taxpayer does anything to earn these royalties. Taxpayer loans the royalties back to retail chain store with no apparent expectation of repayment. The stock exchange agreement, the licensing agreement, the Delaware incorporation, the royalty payments, and the on-going “loans” of the royalties, constitute no more than an elaborate ruse intended to minimize the retail chain store’s state tax liability. In such instances, the Department is entitled to overlook the artifice and determine the business and practical realities of the parties’ relationship and the tax consequences attendant upon that relationship. Gregory v. Helvering 293 U.S. 465, 469 (1935); *See also* Commissioner v. Transp. Trading and Terminal Corp., 176 F.2d 570, 572 (2nd Cir. 1949), *cert denied*, 338 U.S. 955 (1950).

Accordingly, because taxpayer’s intellectual property has acquired an Indiana “business situs,” and because Indiana’s exercise of taxing authority over the income derived from that property does not offend either the Due Process Clause or the Commerce Clause, taxpayer’s income is properly subject to the state’s adjusted gross income tax scheme.

B. Gross Income Tax.

In addition to the adjusted gross income tax, Indiana imposes a tax, known as the “gross income tax,” on the “taxable gross income” of a taxpayer who is a resident or domiciliary of Indiana and on the taxable gross income from Indiana sources by a taxpayer who is not a resident or domiciliary of Indiana. IC 6-2.1-2-2.

Under the regulations governing the gross income tax, “taxable gross income” includes income that is derived from “intangibles.” 45 IAC 1-1-51. The term “intangibles” includes:

notes, stocks in either foreign or domestic corporations, bonds, debentures, certificates of deposit, accounts receivable, brokerage and trading accounts, bills of sale, conditional sales contracts, chattel mortgages, “trading stamps,” final judgments, leases, royalties, certificates of sale, choses in action *and any and all other evidences of similar rights capable of being transferred, acquired or sold.* (*Emphasis added*). Id.

In order for Indiana to impose the gross income tax on income derived from taxpayer’s intangibles, the Department must determine that the income is derived from a “business situs” within the state. Id. The regulation states that taxpayer has established a “business situs” within the state “[i]f the intangible or the income derived therefrom forms an integral part of a business regularly conducted at a situs in Indiana . . .” Id. Once the taxpayer has established a “business situs” within the state, “and the intangible or the income derived therefrom is connected with that business, either actually or constructively, the gross receipts of those intangibles will be required to be reported for gross income tax purposes.” Id.

For purposes of the state’s gross income tax, the Department concludes that income derived from the taxpayer’s licensing of the intellectual property, is income derived from a “business situs” within Indiana and is properly subject to the state’s gross income tax scheme. The intellectual property is exclusively licensed to the retail chain store. The intellectual property is “localized” within the state in the sense that the Indiana chain store employs the property to enhance the

value of goods sold within the state to Indiana customers. Taxpayer would derive no income from the intellectual property but for the fact that the intellectual property was licensed for use within Indiana and then actually used within Indiana in conjunction with retail sales occurring within the state.

Accordingly, because the intangible intellectual property has acquired a business situs within the state and because the income at issue is “connected with that business, either actually or constructively,” the income is subject to the state’s gross income tax.

FINDING

Taxpayer’s protest is respectfully denied.

II. Apportionment Formula.

Taxpayer sets out a second challenge to the proposed assessments by challenging the manner in which the audit apportioned taxpayer’s income.

Indiana imposes a tax on a corporation’s adjusted gross income derived from sources within Indiana. IC 6-3-2-1(b). Where the corporation earns business income from sources within the state and from sources outside the state, the adjusted gross income is determined by an apportionment formula. IC 6-3-2-2(b). The apportionment formula multiplies the corporation’s total business income by a fraction the numerator of which is a property factor plus a payroll factor plus a sales factor, and the denominator of which is three. *Id.* “The property factor is a fraction, the numerator of which is the average value of the taxpayer’s real and tangible personal property owned or rented and used in this state during the taxable year” IC 6-3-2-2(c).

Since taxpayer did not prepare Indiana income tax returns or report Indiana income, the audit prepared returns on taxpayer’s behalf. According to the audit, this “had to be calculated using information supplied by the taxpayer.” The audit report indicated that taxpayer’s “rent and payroll [] never exceeded \$2000 . . . [that] the rent and payroll [was] not related to the earnings of the royalty income, and therefore have not been included in the apportionment calculation.”

Taxpayer objects to the audit’s methodology suggesting that the audit’s apportionment methodology unduly distorted the amount of taxpayer’s adjusted gross income. However, taxpayer has provided no alternative other than to maintain that, “the taxes asserted in the notices are out of all appropriate proportion to, and do not fairly represent the business, if any, conducted by [taxpayer] in Indiana and therefore are unconstitutional.” Taxpayer insists that, “An alternative apportionment formula must be applied to reflect a less distortive income apportionment.”

IC 6-3-2-2(l) provides as follows:

If the allocation and apportionment provisions of this article do not fairly represent the taxpayer’s income derived from sources within the state of Indiana, the taxpayer may

petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable;

- (1) separate accounting;
- (2) the exclusion of any one (1) or more of the factors;
- (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
- (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

The Department has stated that, "All corporations subject to the allocation and apportionment provisions of IC 6-3-2-2(b) to (n) shall apportion their business income by use of the 3-factor formula . . . unless the taxpayer obtains a ruling which permits, or the Department requires, the use of a different formula which more fairly reflects its income from Indiana sources." 45 IAC 3.1-1-39.

The audit departed from the standard three-factor apportionment formula when it chose to eliminate consideration of the property and payroll factors. The audit did so because the amounts of the taxpayer's rental and payroll expenses never exceeded \$2,000 during the three audited years and because the identifiable rental and payroll expenses were unrelated to the apportioned royalty income. Because the payroll and property expenses were negligible in relation to the amounts of royalty income and because the expenses were unrelated to that royalty income, the audit was correct in excluding the payroll and property factors from the standard apportionment calculation because including the two factors would not have accurately reflected taxpayer's Indiana sourced royalty income.

FINDING

Taxpayer's protest is respectfully denied.

III. Ten-Percent Negligence Penalty.

Taxpayer argues that the Department should exercise its discretion to abate the ten-percent negligence penalty imposed pursuant to IC 6-8.1-10-2.1(a). Taxpayer maintains that the Department has been inconsistent in its stance on taxation of income attributable to intellectual property.

IC 6-8.1-10-2.1(d) provides potential relief from imposition of the penalty. The statute states that if a person – subject to the negligence penalty imposed under IC 6-8.1-10-2.1(a) – can demonstrate that the failure to file a tax return, pay the full amount of tax shown on the person's return, timely remit tax held in trust, or pay a deficiency determined by the Department, was due to reasonable cause and not due to willful neglect, the Department shall waive the penalty. 45

IAC 15-11-2(b) defines “negligence” as the failure to use the “reasonable care, caution, or diligence, as would be expected of an ordinary reasonable taxpayer.” Negligence results from a “taxpayer’s carelessness, thoughtlessness, disregard, or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations.”

In order to waive the negligence penalty, the taxpayer must demonstrate that its failure to pay the full amount of tax was due to “reasonable cause.” 45 IAC 15-11-2(c). Taxpayer may establish “reasonable cause” by “demonstrat[ing] that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed” Id. In determining whether “reasonable cause” exists, the Department may consider the nature of the tax involved, previous judicial precedents, previous Department instructions, and previous audits. Id.

Even given taxpayer’s argument that issues related to the taxation of income received from intellectual property is an unsettled area of Indiana law, the Department is unable to agree that taxpayer’s decision not to file Indiana tax returns was an exercise in “ordinary business care and prudence” 45 IAC 15-11-2(c). Taxpayer’s decision to report none of the Indiana royalties as Indiana income or to obtain direction from the Department concerning the taxability of this income is not suggestive of the “reasonable care, caution, or diligence, as would be expected of an ordinary reasonable taxpayer.” 45 IAC 15-11-2(b).

FINDING

Taxpayer’s protest is respectfully denied.